Eidelman Virant
CAPITAL

Quarterly Letter — June 2011

Dear Clients & Friends,

The S&P 500 stock index finished the volatile second quarter essentially unchanged, holding its first half gain of 6%. The key headlines moving the markets were budget problems in Greece, the end of the Federal Reserve's quantitative easing program (QE2), debt ceiling concerns in the U.S., and continued monetary tightening in China. Nevertheless, stocks were resilient as earnings grew and low interest rates caused stocks to remain attractive alternatives to fixed income.

Our value composite underperformed the S&P 500 by a few percentage points in the second quarter. Key detractors of performance were Micron Technology (MU), Pan American Silver (PAAS) and CPI Corp (CPY) which were somewhat offset by gains in Japanese small-cap stocks (DFJ) and healthcare companies such as United Healthcare (UNH). After being one of the best performers in the first quarter, Micron shares gave back most of its gains as DRAM and NAND Flash spot prices unexpectedly declined. PAAS shares suffered a setback over political concerns that Peruvian President-Elect Ollanta Humala will raise mining taxes to finance higher social spending. Despite recent share weakness, PAAS continues to capitalize on high silver prices by growing EPS more than 100% year-over-year. We think shares of PAAS provide a hedge against inflation while taking advantage of the relative undervaluation of silver equities compared to silver bullion prices. We think both holdings remain significantly undervalued and offer attractive expected returns from current levels.

A common question we get asked from clients is "how do we evaluate a security after it experiences a fall in price?" If we feel our investment thesis and the company's intrinsic value has been impaired, we would likely sell. Conversely, if the problems seem temporary, it may be a great opportunity to own it at an even cheaper price.

For instance, since purchasing and writing about CPI Corp (Ticker CPY) in last quarter's letter, the stock declined significantly on news that same store sales were down a more-than-expected 7%. We met with CFO Dale Heins at CPI headquarters to dig deeper into the recent announcement. While disappointed with short-term challenges, Dale reiterated his reasons for long-term optimism which included continued growth from Babies 'R' Us stores, Bella wedding business, general economic improvement, and impactful cost cutting. In combination with our own analysis, we are convinced that CPY shares still represent a great value and we are still excited about the prospects of a strong rebound in earnings and a possible buyout of the company.

Some of our biggest winners have suffered declines before rebounding and exceeding our price targets. One example is electric utility PNM Resources (PNM). Over the past three years, our thesis on PNM came to fruition. PNM shares rebounded back above tangible book value as the regulatory commission increased their entitled return and granted relief on their fuel-adjustment clause resulting in an earnings comeback. Shares of Forest Labs have also been a winner as shares have nearly doubled from our average purchase price two years ago. Continued cash flow generation from key drugs Lexapro and Namenda, abating fears surrounding healthcare reform, and recent involvement of activist Carl Icahn drove shares up to our target price.

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We remain optimistic about U.S. stocks and in particular our portfolio holdings. Our key reasons are valuations, investor sentiment, and global growth. The S&P 500 market average is currently trading at only 13.5x forward earnings, a 20% discount to its 20 year average of 17x. Being value investors, our median holding trades at 11x earnings, a 35% discount to the market average. With the current 10-year treasury bond at just 3.1%, current equity valuation levels imply superior returns going forward. Investor sentiment is another important indicator as stocks tend to "climb a wall of worry" and perform better when investors are skeptical. A low consumer confidence index of 58 (30 yr avg. = 98) and an Investor's Intelligence bullish reading of 39% (30 yr avg. = 45%) show that current sentiment is modestly low which bodes well for future returns.

Strong worldwide growth should continue to benefit U.S. multinational companies and industrial commodities like coal and oil. Current levels of GDP growth have historically been a sweet spot for stock market returns. According to the World Bank, global GDP is expected to grow 3.2 percent in 2011 before edging up to 3.6 percent in 2012. U.S. GDP is estimated to grow at 2.6 and 2.9 percent respectively over these periods. In 22 different years where U.S. GDP growth measured between 2-4%, the stock market has averaged a 13.5% annualized return with just 3 down years.

While we remain optimistic towards equities as a way to grow wealth in the long run, more and more advisors are venturing into "alternative" assets such as commodities, real estate, hedge funds, and emerging market debt to reach for their investment objectives. Forced by poor stock market results, many advisors are simply dividing customer portfolios into as many different assets as possible. This approach is commonly referred to as the "Asset Allocation Model." In the following letter, I will compare the Asset Allocation Model to our value-oriented approach and why I think our approach offers the better risk/return profile, fee structure, comfort, historical track record, and is the right approach at the right time. In short, it gives me a way to show why we think our clients' portfolios are best positioned for the future. If you have any questions, please don't hesitate to give me a call.

Sincerely,

Tom Eidelman, CFA
Vice President

PITFALLS OF THE ASSET ALLOCATION MODEL

BY TOM EIDELMAN

At Eidelman Virant Capital, our key objective is to help our clients achieve superior risk-adjusted investment returns. Over time, we have helped clients achieve this goal in popular asset classes such as large and small cap stocks as well as municipal and corporate bonds. When the opportunity existed we also invested in what is now considered "alternative" investments including real estate investment trusts (REITS), commodity stocks & ETFs, master limited partnerships, mortgage-backed securities, and high yield debt. We view the public securities markets as a buffet where we pick the best individual investments off the menu. The ability to compare value among different securities such as a high yield bond to a small cap stock and our flexible mandate to purchase the best option is a key reason why our long-term investment returns have achieved superior performance while incurring less risk.

The Asset Allocation Model

More and more professionals have recently adopted a different and *easier* investment approach: the asset allocation model. The goal of this strategy is to attain average returns through broad diversification and low fees.

Practitioners of the asset allocation model often show two key charts to illustrate their point. The first is a colorful pie chart showing the percentage breakdown of assets to illustrate diversification (Chart A). The second is a list of asset classes and their historical returns (Chart B). Once a portfolio is allocated along these lines, there is very little upkeep other than a bit of rebalancing every so often. When administered at a low management fee and using low-cost index funds, we believe this can be a reasonable investment approach.

Chart A: The Asset Allocation Model

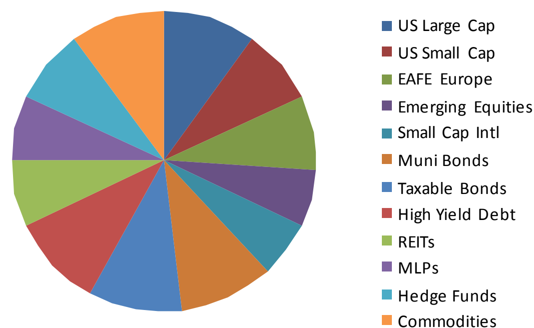


Chart B: Asset Class Historical Performance

		10 Year
	Domestic Equities	
1	Large Cap Growth (Russell 1000 Growth)	3.0%
2	Large Cap Value (Russell 1000 Value)	4.5%
3	Small Cap Growth (Russell 2000 Growth)	6.4%
4	Small Cap Value (Russell 2000 Value)	9.0%
	International Equities	
5	Non-U.S. Stocks (MSCI EAFE Index)	5.4%
6	Non-U.S. Stocks LC (MSCI EAFE Index)	1.1%
7	Emerging Markets (MSCI Emerging)	17.1%
8	Non-U.S. Small Cap (MSCI EAFE Small Cap)	10.5%
	Fixed Income	
9	Municpal Bonds (Barclays 5-Year Muni Bond)	4.6%
10	Taxable Bonds (Barclays Aggregate Bond)	5.6%
11	High Yield Bonds (Barclays High Yield)	8.6%
	Other	
12	Domestic REITs (NAREIT Equity Index)	11.5%
13	Non-U.S. REITs (EPRA/NAREIT Golbal ex-US)	11.4%
14	Commodities (Dow Jones UBS)	7.1%
15	MLPs (Alerian MLP Index)	17.8%
16	Hedge Fund Long/Short (HFRI Equity)	5.9%
17	Hedge Fund of Funds (HFRI FOF)	4.1%

Note: Returns are 10-year compounded annualized returns including dividends for period ending 3/31/11.

Why don't we recommend the "Asset Allocation Model" described above? In short, because we think we can do better.

Asset allocators can suffer from one or more of the following pitfalls: 1) Not knowing what you own, 2) Ignoring value, 3) Paying double fees and 4) Misleading performance.

Know What You Own

We take pride and comfort in knowing the investments that we own. When researching a company, we thoroughly analyze their competitive advantages, management incentives, insider ownership and often meet directly with management. We scrutinize the financial statements and SEC filings, including a careful review of the footnotes looking for red flags and information others may overlook. In the end, our clients have a portfolio of individual holdings from which we are happy to discuss the investment rationale and how we view its expected return prospects.

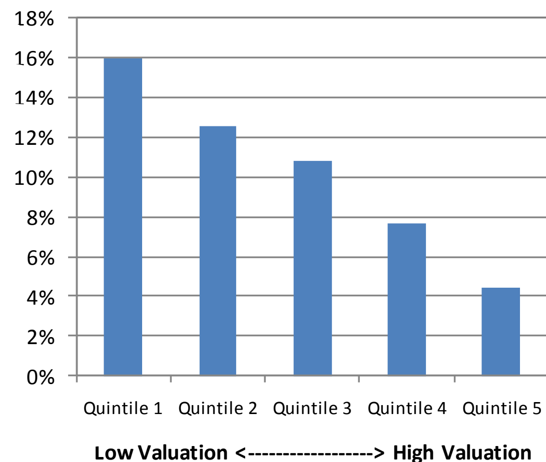
Asset allocating advisors can't possibly understand everything in which they are invested. In fact, I worry some advisors may not even know what the asset class is. Can the advisor tell you what an MLP is and what the largest holding is in the fund? How about the location of the real estate properties inside a REIT index? How about a name of one of the small-cap international stocks in the index? Does the invested-in country recognize individual property rights and rule of law?

Many of these asset classes are bought on faith that they are buying a properly priced basket of companies with good assets and earning power. What if they aren't? Investors have lost millions in hard-to-understand companies and newfangled investment products like collateralized debt obligations (CDO) and Auction Rate Securities (ARS). Warren Buffett said it simply: "We try to stick with businesses we believe we understand." At Eidelman Virant, we do too.

Ignoring Value

Our studies show that the cheapest valued assets (as measured by low Price/Earnings, Price/Book, and other ratios) outperform over time (See Chart C). We concentrate our investments in countries, industries, and stocks which are in the lowest quintile of valuation while avoiding high priced areas (See Chart C).

Chart C: Valuation (PE Ratio) vs. Performance



Note: Chart shows historical annual performance of stocks grouped by P/E ratio. Source: Ned Davis Research (9/20/80-6/30/2010)

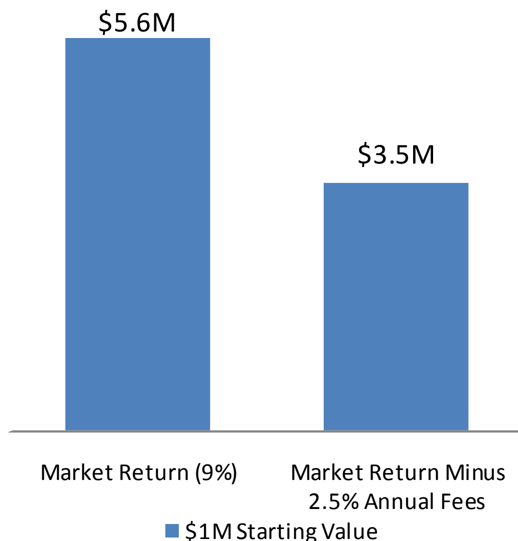
An asset allocation approach buys all stocks in the index regardless of valuation. As certain sectors go up in price, like the technology stocks in the internet boom or financial stocks before the credit crisis, passive allocation ends up owning a higher allocation to these areas to match their higher weighting in the index. The result can be owning an oversized position in the most vulnerable overvalued assets. We believe strongly that valuation is key to attaining great results and avoiding big losses.

Paying a Double Fee

Many financial advisors who use asset allocation charge a full 1% fee and then just allocate to numerous mutual funds who charge additional fees. Using industry averages of 1% advisor fee, 1.2% mutual fund fee, and .30% mutual fund commission fee, this can add up to total fees of 2.5% of assets. Paying fees on top of fees is a sure way to obtain below average net investment performance.

High fees for average performance can make a huge difference over time. Over a 20-year holding period, such fees could be the difference between earning 5.6 times your investment vs. only 3.5 times. $1 million invested would end up only growing to $3.5 million versus $5.6m without fees (See Chart D on next page).

Chart D: Double Fee Impact on Performance



Note: Assumes $1 million starting value compounds at 9% for twenty years. Compares no-fee portfolio versus one with fees of 2.5% annually.

Our goal is to achieve superior net performance with less risk. Please note that our GIPS verified investment performance posted on our website is net of all fees and commissions. Given our level of service, rigorous research, and performance record, we believe our management fees offer great value.

Misleading Performance

Many advisors using the asset allocation approach do not show their actual performance in marketing materials. Most often, asset allocators will show a list of asset classes (See Chart B from before) and show how they would have performed if they had owned them. The only problem is that they didn't own them! In fact, many of these asset class ETFs weren't even publically available. The vast majority of funds dedicated to MLPs, REITs, Commodities, Gold, small-cap emerging equities, emerging market debt, and many other alternative assets have only become available in the past few years.

The implication of showing these assets performance track record is that it will continue. It is my belief that since these asset classes are now freely available (which has driven the prices up) future performance of these assets will be well below their 10-year averages. Hypothetical performance and diversification may offer a misleading look into past and future performance.

We have many clients who have been with Eidelman Virant for more than twenty years and we take great pride in our company history. Our performance record is based on actual results, calculated in accordance with the Global Investment Performance Standards (GIPS) and verified by the leading financial 3rd-party verification company Ashland Partners. We will continue to utilize the same value-oriented approach that we have used for more than 25 years.

Right Approach at the Right Time

Many financial advisors may be diversifying away from the U.S. S&P 500 into other asset classes just when they should be doing the opposite. Many fail to realize a key reason for the S&P 500 10-year underperformance was its overvalued 25x earnings valuation at the end of 2001. Now that the S&P 500 has contracted down to a reasonable 16x, future returns should be much closer to its 20-year historical average of 9%.

Meanwhile, many of the other asset classes have doubled and are trading at above average valuation levels. While there are some attractive individual securities within each asset class, we think it may be the wrong time to overweight such broad groups as small cap stocks, commodities, REITs, emerging markets and high yield debt.

We are sticking with what we have always done and with what makes sense: investing where we find value. After looking at securities across different types, sizes and industries, we have handpicked each security to position our portfolios to achieve the best risk-adjusted return possible. We are confident that adhering to sound value-investing principles is the right approach at the right time.

Disclosure: This newsletter is for informational purposes only and does not constitute a complete description of our investment advisory services. This newsletter is in no way a recommendation of any security or a solicitation or offer to sell investment advisory services.